

IT 02-15

Tax Type: Income Tax

**Issue: Business/Non-Business (General)
Commerce Clause (U.S. Const.) Controversy**

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

"LE CROISSANT" CORPORATION,
Taxpayer

No. 01-IT-0000
FEIN: 34-0000000
TYE: 1993-1995

Charles E. McClellan
Administrative Law Judge

RECOMMENDATION FOR DECISION

Appearances: Deborah H. Mayer and Ralph P. Basset, Special Assistant Attorneys General, for the Department of Revenue; Charles M. Steines, Jones, Day, Reavis & Pogue, for "Le Croissant" Corporation.

Synopsis:

This matter arose from a protest filed by "Le Croissant" Corporation ("Le Croissant" or "taxpayer") to a Notice of Deficiency issued by the Department for income tax liabilities for the years 1993, 1994 and 1995. A pre-trial conference was held on January 9, 2002, setting forth two issues to be addressed, to wit:

1. Whether the gains on the sale of the "Greenjeans, Inc." ("Greenjeans") stock realized in 1993, 1994 and 1995 by "Le Croissant Overseas Trading Corporation" ("LOTC"), a member of "Le Croissant" Corporation's unitary business group, are

properly treated as business income as defined in 35 ILCS 5/1501(a)(1)¹ or non-business income as defined in 35 ILCS 5/1501(a)(13).

2. Whether characterization of the gains realized in 1993, 1994, and 1995 by LOTC on the sale of the "Greenjeans" stock as business income violates the Due Process and Commerce clauses of the U.S. Constitution.

An evidentiary hearing was held on April 24 and 25, 2002, following which, both parties filed briefs.

I recommend that the Notice of Deficiency be canceled.

Finding of Facts:

1. "Le Croissant" Corporation ("Le Croissant") was incorporated in 1928. Tr. p. 129.
2. In 1979, "Le Croissant's" business was conducted in three segments. "Le Croissant's" core business was the developing, manufacturing and marketing of specialty organic chemicals principally for lubrication, motor fuel additives and additives for coatings, paints and similar products for use in industrial, transportation and marine markets. Tr. pp. 114-115, 129-130.
3. "Le Croissant's" second business segment was agribusiness, producing genetically enhanced and improved seeds with the ability to exude biotoxins which would protect them from insects or fungus attack, producing greater crop yields. Tr. pp. 124-125, 130.
4. "Le Croissant's" third business segment was conducted in a subsidiary of "Le Croissant" called "Le Croissant" Enterprises, Inc., a Nevada corporation incorporated on September 12, 1979 ("LCEI" Nevada). It invested in emerging

¹ Unless otherwise noted, all statutory references are to 35 ILCS 5/101, *et seq.*, the Illinois Income Tax

technology companies engaged in biotechnology, computers, and advanced chemicals. This subsidiary's name was changed in 1985 to "LCEI" Holdings, Inc.² It was liquidated into "Le Croissant" in 1988. Tr. pp. 116-120, 129-130. Taxpayer Ex. No. 6.

5. "LCEI" Nevada made investments in companies engaged in newly developing sciences, the objective being to develop new products outside "Le Croissant's" specialty chemical business. Tr. p. 124.
6. By 1987, "Le Croissant" through "LCEI" Holdings, Inc. (Nevada) was no longer interested in investing in companies outside the core business. Accordingly, investments related to the agribusiness were consolidated in that segment of "Le Croissant". Investments that were not engaged in activities related to "Le Croissant's" specialty chemical business were liquidated as opportunities permitted. Tr. pp. 127-128.
7. "LCEI" Nevada never had a presence in Illinois. Tr. p. 120.
8. "Le Croissant's" only facility in Illinois during the period 1979 through 1995 was a sales office located in "Someplace", Illinois out of which the company marketed its lubricants and fuel additives. Tr. p. 131.
9. The "Someplace" sales office had five or six professional staff and a small administrative staff. Tr. p. 132.
10. The activities of the "Someplace" office had no relation to the business of "Greenjeans", Inc. *Id.*

Act ("ITA" or the "Act").

² This corporation is sometimes referred to as "Old Le Croissant" in the transcript. In this recommendation it will consistently be referred to as "'LCEI" Nevada".

11. "Le Croissant" Enterprises, Inc., a Delaware corporation ("LCEI" Delaware), was incorporated by "Le Croissant" as a wholly owned subsidiary in December 1985. Tr. pp. 119, 132; Taxpayer Ex. Nos. 5, 7.
12. "LCEI" Delaware was incorporated as holding company for investments. Tr. p. 134.
13. "Le Croissant" first invested in "Greenjeans" in September of 1979 with a \$10 million purchase of 25,000 shares of preferred stock convertible into common stock at the rate of 10 shares of common stock for each share of preferred stock. Tr. p. 137, Taxpayer Ex. No. 8.
14. "Le Croissant" converted the "Greenjeans" preferred stock to common stock that it contributed to "LCEI" Nevada upon its formation. Tr. p. 138.
15. In February 1980 "LCEI" Nevada purchased 138,000 shares of "Greenjeans" shares for \$5.2 million. Tr. pp. 138-139, Taxpayer Ex. No. 8.
16. In June 1980 "Greenjeans" declared a four for one stock split. Tr. p. 142, Taxpayer Ex. No. 8.
17. In February 1983 "LCEI" Nevada sold 134,000 shares of "Greenjeans", after which, in March 1983, "Greenjeans" stock split again in a three for two split,³ and "LCEI" Nevada sold another 76,012 shares in April and May of 1983. Tr. pp. 142-143, Taxpayer Ex. No. 8.
18. "LCEI" Nevada sold 100,000 shares of "Greenjeans" stock in 1985. *Id.*

³ The transcript indicates that the split was two for one, but Taxpayer Ex. No. 8 states that the split was three for two. This inconsistency is immaterial to the issues involved in this matter.

19. In November of 1985 "LCEI" Nevada, now renamed "LCEI" Holdings, Inc., purchased a warrant to purchase "Greenjeans" stock for \$434,700. *Id.*
20. In January and February 1986 "LCEI" Nevada sold 200,000 shares of "Greenjeans" stock. Tr. p. 144, Taxpayer Ex. No. 8.
21. In February 1986, "Greenjeans" declared a two for one stock split. *Id.*
22. In December 1986 "LCEI" Nevada sold 10,000 shares of "Greenjeans" stock. *Id.*
23. In January and February 1987, "LCEI" Nevada sold 40,000 shares and 20,000 shares of "Greenjeans" stock, respectively. *Id.*
24. In February 1987 "Greenjeans" declared another two for one stock split after which "LCEI" Nevada owned 6,883,150 shares. *Id.*
25. During the period June through November 1987, "LCEI" Nevada sold 360,000 shares of "Greenjeans" stock. *Id.*
26. In December 1987 "LCEI" Nevada donated 21,000 shares of "Greenjeans" stock to the "Le Croissant" foundation. *Id.*
27. In 1988 "LCEI" Nevada sold 175,000 shares of "Greenjeans" stock. Tr. p. 145.
28. In 1989 after "LCEI" Nevada was liquidated into "Le Croissant", "Le Croissant" sold 43,600 shares of "Greenjeans" stock and in March 1990 it donated 170,000 shares, which it received in the liquidation of "LCEI" Nevada, to the "Le Croissant" Foundation. After these dispositions, "Le Croissant" owned 5,823,550 shares of "Greenjeans" stock. *Id.*
29. During the period of June through November of 1990, "Le Croissant" capitalized LOTC by a transfer of 5,823,550 shares of "Greenjeans" stock to LOTC. 500,000 of these shares were transferred back to "Le Croissant" as a dividend for a net

transfer to LOTC of 5,323,550 shares. Tr. pp. 146-149, Taxpayer Exs. No. 8, 9, 9a and 9b.

30. In 1990 "Le Croissant" exercised the warrant it purchased in 1985 and acquired 180,000 shares of "Greenjeans" stock for \$2.25 million. Tr. p. 150, Taxpayer Ex. No. 8.
31. In 1990 "Le Croissant" sold 340,000 shares of "Greenjeans" stock. Tr. p. 151, Taxpayer Ex. No. 8.
32. In September 1990 LOTC sold 2,661,775 shares of "Greenjeans" stock. Tr. p. 151, Taxpayer Ex. No. 8.
33. Sometime in 1990 or 1991, "Le Croissant" transferred to LOTC the remaining shares of "Greenjeans" stock that it held. *Id.*
34. In 1993 LOTC sold 1,001,776 shares of "Greenjeans". In 1994 it sold 869,100 shares and donated 300,000 shares to the "Le Croissant" Foundation. In 1995 it sold 830,899 shares which were the last of the shares of "Greenjeans" owned by "Le Croissant" and its affiliates. *Id.*, Tr. p. 152.
35. "Le Croissant" and its affiliates never owned more than 20% of the outstanding stock of "Greenjeans". Tr. p. 153.
36. LOTC never had a presence in Illinois or engaged in business activities in Illinois. Tr. p. 154.
37. "Le Croissant" invested in "Greenjeans" in 1979 thinking it might be the next Microsoft or Apple Computer because it was a leader in the new science of recombinant DNA technology.⁴ Tr. p. 155.

⁴ Taxpayer's witness explained recombinant DNA technology as the process of inserting foreign genes into foreign organisms to produce new, different or enhanced products. Tr. pp. 155-156.

38. "Greenjeans" is a biotechnology company that discovers, develops, manufactures and markets human pharmaceuticals for significant medical needs. Tr. pp. 159-160.
39. The recombinant DNA technology activities of "Greenjeans" have no application to the specialty chemical, marine or agribusiness of "Le Croissant" because the technologies are entirely different. Tr. pp. 156-157, 294-295.
40. The recombinant DNA technology for human purposes engaged in by "Greenjeans" is completely different from the seed technology that is used in agriculture and different from the technology involving animals. The technology of one of these disciplines cannot be applied to any other of these disciplines. *Id.*
41. Neither "Le Croissant" nor any of its affiliates have ever been engaged in the same lines of business as "Greenjeans". Tr. p. 160.
42. "Le Croissant" had a representative, "John Doe", on the "Greenjeans" board of directors from 1979 until 1988 when Mr. "Doe" resigned from his employment by "Le Croissant". Tr. pp. 161-162.
43. "Greenjeans" had no representation on the board of directors of "Le Croissant" or its affiliates during the period 1979 through 1995. Tr. p. 162.
44. Neither "Le Croissant" nor any of its affiliates employed any officers or employees who were also officers or employees of "Greenjeans" during the period 1979 through 1995. Tr. p. 162.
45. During the period 1979 through 1995 "Greenjeans" and "Le Croissant", or any of its affiliate, did not share any plant, office or facility, owned or leased. Tr. p. 163.
46. During the period 1979 through 1995, "Greenjeans" provided no legal services, accounting services, tax services, financial services, or insurance services or

coverage to "Le Croissant" or any of its affiliates, nor did "Le Croissant" or any of its affiliates provide such services to "Greenjeans". Tr. pp. 163-165.

47. During the period 1979 through 1995, "Greenjeans" and "Le Croissant" and its affiliates had separate and independent personnel, hiring policies, and pension and employee benefit plans. Tr. p. 165.
48. During the period 1979 through 1995, neither "Le Croissant" nor any of its affiliates sold any products to "Greenjeans" and "Greenjeans" sold no products to "Le Croissant" or to any of its affiliates. Tr. pp. 165-166.
49. Neither "Le Croissant" nor any of its affiliates attempted to control, supervise or influence the method "Greenjeans" used to sell the products it produced during the period 1979 through 1995. Tr. p. 166.
50. During the period 1979 through 1995, neither "Le Croissant" nor any of its affiliates sold to the same customers or target market as did "Greenjeans". *Id.*
51. During the period 1979 through 1995, neither "Le Croissant" nor any of its affiliates engaged in any joint marketing or advertising campaign with "Greenjeans". Tr. p. 167.
52. During the period 1979 through 1995, neither "Le Croissant" nor any of its affiliates sought or obtained any discount or favorable advertising rate because of its association with "Greenjeans". *Id.*
53. During the period 1979 through 1995, neither "Le Croissant" nor any of its affiliates pledged any of the "Greenjeans" stock as security. *Id.*
54. During the period 1979 through 1995, none of the "Le Croissant" companies or "Greenjeans" loaned funds to the other or guaranteed debt of the other. Tr. p. 176.

55. In 1982 "Le Croissant" signed a research agreement with "Greenjeans" to fund research using "Greenjeans"'s technology to produce vitamin C (ascorbic acid) by a one step biological process. "Le Croissant" was committed to provide up to \$4 million in financing the research that was expected to take five years. "Le Croissant" actually contributed \$2.1 million. By 1985, a way had not yet been devised to produce vitamin C by a one-step biological process and the 1982 agreement terminated. However, the parties decided to continue the research, and in 1985 they formed a partnership to continue the research into the development and production of vitamin C by a biological process. The partnership was named "ABC" Associates. "Le Croissant"'s interest in the partnership was owned by "Electric Galloway", Inc. (Delaware), a second tier subsidiary of "Le Croissant" owned by "LCEI" Delaware. "LCEI" Delaware contributed the \$2.1 million research project to "ABC" Associates. "Greenjeans"'s ownership in the partnership was held by "XYZ" Ventures, a second tier subsidiary of "Greenjeans". "ABC" Associates contracted out the research on the genetic pathway to "Greenjeans" and some small chemical research to "Le Croissant". It did not conduct any research itself. "ABC" Associates had no production facilities, so in 1985 it contracted with (a pharmaceutical company) to produce the vitamin C if a feasible one step biological method to produce it could be developed. No economical method of producing vitamin C by biological process was developed and Pfizer terminated its agreement in 1990. The research conducted by "Greenjeans" and "ABC" Associates never resulted in the commercial production of vitamin C, nor did it relate in any

way to the business of "Le Croissant" or its affiliates and they never utilized the research in any way. Tr. pp. 168-175.

56. On December 13, 2000, the Department issued its Notice of Deficiency to the "Le Croissant" Corporation. Dept. Ex. No. 1.

Conclusions of Law:

The Business/Nonbusiness Income Issue

The first issue for consideration is whether the gains realized on the sale of the "Greenjeans", Inc. ("Greenjeans") stock by LOTC during the years at issue, 1993, 1994 and 1995, are properly treated as business income as defined in 35 ILCS 5/1501(a)(1) or nonbusiness income as defined in 35 ILCS 5/1501(a)(13).

The Act defines the term "business income" as follows:

The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business, net of the deductions allocable thereto, and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. Such term does not include compensation or the deductions allocable thereto. 35 ILCS 5/1501(a)(1)

The Act defines the term "nonbusiness income" as follows:

The term "nonbusiness income" means all income other than business income or compensation. 35 ILCS 5/1501(a)(13)

A taxpayer that claims that income is nonbusiness income has the burden of clearly proving this fact. *Texaco-Cities Service Pipeline Co. v. Director of Revenue*, 182 Ill.2d 262, 695 N.E.2d 481 (1998) The courts have interpreted the statute as providing for a two-prong test to determine whether income is business income or nonbusiness income. *National Realty and Investment Co. v. Dept. of Revenue*, 144 Ill.App.3d 541, 494 N.E. 2d

924 (2nd Dist. 1986), *Kroger Co. v. Dept. of Revenue*, 284 Ill.App.3d 1996, 673 N.E. 2d 710 (1st Dist. 1996), *Texaco-Cities Service Pipeline Co. v. Director of Revenue*, *supra*. The first test is the transactional test. The second test is the functional test. "Income is business income under the transactional test if it is 'attributable to a type of business transaction in which taxpayer regularly engages.'" [citation omitted] *Texaco-Cities Service Pipeline Co.*, 182 Ill.2d at 269. The frequency and regularity of the transactions at issue are central considerations in applying the transactional test. *Id.* Under the functional test "all gain from the disposition of a capital asset is considered business income if the asset disposed of was 'used by the taxpayer in its regular trade or business operations.'" [citation omitted] *Id.* Under the functional test the extraordinary nature or infrequency of the sale is irrelevant. [citations omitted] *Id.*

The Transactional Test

The Department argues that the gains involved in this case are business income under the transactional test because "Le Croissant" or "LCEI" Nevada made many investments in technology companies. However, the uncontroverted testimony of taxpayer's witness, Mr. "Barry Gibb",⁵ indicates that these investments were made with excess cash by "LCEI" Nevada in "Le Croissant"'s search for new technology companies that would become successful, go public and be sold for ten times the initial investment. Investing excess cash in companies that have what appear to be promising new technologies in hopes that the investments will prosper, as the taxpayer did prior to 1988, is not the same as buying and selling companies for short term profit in the ordinary course

⁵ Mr. "Gibb" holds a Bachelor of Science degree in chemical engineering and a master's degree in business administration. In 1979 he was the director of process engineering, research and development for "Le Croissant". In 1981 he was vice-president of "Le Croissant" Enterprises, Inc., later becoming a senior vice president in "Le Croissant" responsible for business development. Tr. pp. 113 –114, 121-122.

of a trade or business as a day trader might do on the internet. Rather it reflects a focused plan to invest excess cash as it becomes available. Therefore, the fact that "Le Croissant" invested in new technology companies through a subsidiary, in and of itself, does not make the gains on the sale of the "Greenjeans" stock business income.

In any case, in 1987 the investments that did not relate to "Le Croissant"'s core business in specialty chemicals were liquidated and those that were involved with agribusiness were consolidated into the agribusiness sector of "Le Croissant"'s business. There is no evidence in the record that indicates that "Le Croissant" was buying and selling corporations in the regular course of its business during the years at issue.

"Le Croissant" first invested in "Greenjeans" stock in 1979. Mr. "Gibb" testified that "Le Croissant" invested in "Greenjeans" stock because management "felt that "Greenjeans" might be one of the next Microsofts or Apple [Computer Co.] . . ." Tr. pp. 116, 155. "Greenjeans" was a leader in the new science of recombinant DNA technology and "Le Croissant" personnel believed that "by investing in that company we had a very good chance for a financial big hit." *Id.* In 1980 "LCEI" Nevada made an additional investment in "Greenjeans" stock. Between 1980 and 1990 the "Greenjeans" stock increased in value and split several times. After each stock split, "LCEI" Nevada or "Le Croissant" sold some "Greenjeans" shares or donated "Greenjeans" stock to the "Le Croissant" Foundation. In 1990 "Le Croissant" purchased another warrant to purchase "Greenjeans" stock which it exercised and then transferred all of its "Greenjeans" stock to LOTC. During 1993, 1994 and 1995, LOTC either sold or donated the remaining shares of "Greenjeans" stock that it owned resulting in the gains that are at issue in this case. "Le

Croissant" and its affiliates never owned more than 20% of "Greenjeans's" outstanding stock.

The transactions at issue in this case are the sales of "Greenjeans" stock by "Le Croissant's" subsidiary LOTC during the years 1993, 1994, and 1995. During these years, "Le Croissant" had two core businesses consisting of its specialty chemicals business of lubricants and fuel additives and its agribusiness. It was not engaged in the business of buying and selling corporations during those years. The gains from the sales of "Greenjeans" stock during 1993, 1994, and 1995 were not attributable to a type of business transaction in which the "Le Croissant" regularly engaged. Therefore, the gains on the sale of the LOTC stock were not business income under the transactional test.

The Functional Test

Under the functional test, gain from the disposition of property is business income if the property disposed of was used by the taxpayer in its regular trade or business operations. *National Realty and Investment Co. v. Dept. of Revenue*, *supra*, *Texaco-Cities Service Pipeline Co. v. Director of Revenue*, *supra*. Under the functional test, the relevant inquiry is whether the property was used in the taxpayer's regular trade or business operations. *Kroger Co.*, 284 Ill.App. at 482.

The Department argues that the acquisition and management of the "Greenjeans" stock was related to "Le Croissant's" specialty chemicals and agribusiness. However, Mr. "Gibb's" uncontroverted testimony was that the recombinant DNA technology activities of "Greenjeans" had no application to the specialty chemical or agribusiness of "Le Croissant" because the technologies are different.

The Department attempts to rebut this testimony by citing excerpts from two of the taxpayer's annual reports from 1985 and 1986, seven years before the earliest year involved in this matter. (Dept. Ex. Nos. 13, p.7 and 14, p. 6) These two excerpts describe "Le Croissant"'s efforts at broadening its base in specialty chemicals and the agribusiness by, for example, using biotechnology in agribusiness. However, the documentation relied on by the Department is not relevant to the years or the issues involved in this matter. Also, there is no indication in these excerpts that "Greenjeans" recombinant DNA research activities involving the human genome were related to or connected with "Le Croissant"'s research activities involving petroleum and agricultural products. This documentation does not rebut Mr. "Gibb's" testimony that the "Greenjeans" recombinant DNA research for human applications is completely different from the technology involved in the specialty chemicals and agricultural activities engaged in by "Le Croissant". The Department is making an inference that is not supported by the record.

The Department also argues that "Le Croissant" had a strategic business plan requiring the sale of blocks of "Greenjeans" stock to fund its other business development projects and to help it break even with expenses in the new technologies. This also is an inference not supported by the record. There is no evidence in the record of any strategic business plan requiring the sale of blocks of "Greenjeans" stock to fund other projects or to help it break even with expenses of new technologies.

However, even if the proceeds from the sale of the "Greenjeans" stock were used to fund other business projects, that does not make the gain from the sale of that stock business income. The Department's argument was rejected by the U.S. Supreme Court in *ASARCO, Inc. v. Idaho Tax Commission*, 458 U.S. 307, 102 S. Ct. 3103 (1982) when it

stated that "...[T]he fact that a transaction was undertaken for a business purpose does not change its character.. . The business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently *all* of its operations, including any investment made, in some sense can be said to be for purposes related to or contributing to the corporation's business." [emphasis by the Court] 458 U.S. at 326. The same rule was repeated and applied by the Court in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 789 (1992).

The standard tests for finding income derived from an investment to be business income under the functional test are the presence of centralized management, functional integration or economies of scale. *F.W. Woolworth v. Taxation and Revenue Dept. Taxation of the State of New Mexico*, 458 U.S. 354, 102 S. Ct. 3128 (1982) (holding that New Mexico could not tax a non-resident corporation's gain from the sale of the stock of foreign subsidiaries absent a showing that they resulted from functional integration, centralized management and economies of scale.)

Between "Le Croissant" and "Greenjeans", there was never any centralized management, functional integration or economies of scale. "Le Croissant" never owned over 20% of "Greenjeans"'s outstanding stock. With one exception during the years 1979 through 1988, the two entities never shared directors. They never shared officers or employees. Thus, there was no centralization of management.

To demonstrate functional integration, the record would have to show that "Le Croissant" used the "Greenjeans" stock or its technology, personnel or facilities in its regular trade or business operations. The record demonstrates that not to be the case. No employees transferred from one company to the other. Neither company provided the

other, or shared with the other, legal, accounting tax, insurance, personal, or any other corporate service. "Le Croissant" never used the "Greenjeans" stock as security for loans or for any other operational purpose. "Le Croissant" never used "Greenjeans'" technology in its business during the years at issue. "Le Croissant's" regular trade or business during the years at issue was in specialty chemicals, such as fuel additives and lubricants, and in its agribusiness. There is no evidence in the record that suggests that the "Greenjeans" technology was used in "Le Croissant's" specialty chemical business or in its agribusiness. Thus, there was no functional integration.

Neither company purchased any product or shared technology with the other company. In 1982, "Le Croissant" and "Greenjeans" did sign a research agreement to fund research using "Greenjeans's" technology to produce vitamin C (ascorbic acid) by a one step biological process. The research was never successful, and it did not relate in any way to the business of "Le Croissant" or its affiliates. Because the project was unsuccessful, the agreement with (a pharmaceutical company) to produce vitamin C terminated in 1990, three years before the earliest year involved in this matter. "Le Croissant" never utilized the research in any way. As noted above, "Greenjeans" and "Le Croissant" never shared administrative services. Thus, there were no economies of scale.

The situation addressed by the Court in *Allied Signal*,² *supra*, is quite similar to the factual situation in this case. Allied Signal was the successor-in-interest to Bendix Corp. that had invested in the stock of ASARCO Co. The Court found that in the relationship between Allied Signal and ASARCO there was no centralized management, functional integration or economies of scale. Accordingly, the Court held that the gain Allied Signal realized on the sale of an investment it had in ASARCO was not business income because

the two companies were discrete businesses the activities of which were not related to each other, and Allied Signal could not exercise control of ASARCO because it owned only 20.6% of ASARCO's stock. 504 U.S. at 788. In summary, the record establishes that the gains on the sale of the "Greenjeans" stock were not business income under the functional test.

As the taxpayer points out in its brief, the Department's regulations also support the taxpayer's argument that the gains on the "Greenjeans" stock were non-business income. The regulation at 86 Ill. Admin. Code § 100.3010(d)(5), Example F posits the following example:

A corporation is engaged in a multistate glass manufacturing business. It also holds a portfolio of stock and interest-bearing securities, the acquisition and holding of which are unrelated to the corporation's trade or business operations. The dividends and interest income received are nonbusiness income.⁶

Contrary to the Department's assertion, "Le Croissant's" situation is identical to that of the corporation described in this example in that the "Greenjeans" stock and business was unrelated to "Le Croissant's" trade or business, *i.e.*, specialty chemicals and agribusiness.

The tests prescribed by the U.S. Supreme Court in the cases cited above and the Department's regulation applied to the facts of this case clearly establish that the gains realized by "Le Croissant" through LOTC on the sales of the "Greenjeans" stock during the years at issue are non-business income.

⁶ Capital gains are treated the same as dividends for constitutional purposes. *Allied Signal*, 504 U.S. at 780.

The Constitutional Issue

The final issue for consideration is whether characterization of the gain realized in 1993, 1994, and 1995 by LOTC on the sale of the "Greenjeans" stock as business income violates the Due Process and Commerce clauses of the U.S. Constitution.

The Department maintains that taxation of the capital gains in question does not violate either the Due Process Clause or the Commerce Clause. The Department asserts that "Le Croissant" failed to demonstrate by clear and cogent evidence that Illinois is attempting to tax extraterritorial values and that it failed to apply any of the precedents cited in its briefs to the facts of this case

The Department's assertion that "Le Croissant" failed to apply any of the precedents it cited in its briefs to the facts of this case is incorrect. Beginning on page 19 of its brief and continuing to the end, the taxpayer notes in great detail the factual similarities in its case to the facts in the cited cases, i.e., *Hercules, Inc. v. Dept. of Revenue*, 324 Ill.App.3d 329, 753 N.E.2d 418 (1st Dist. 2001) app. den. 197 Ill.2d 560, 763 N.E.2d 770, *Allied Signal, supra*, and *ASARCO, supra*.

The Department asserts that there is no documentary evidence to support Mr. "Gibb's" testimony that "Greenjeans's" business did not relate in anyway to "Le Croissant's" business in Illinois. In essence, the Department argues that the taxpayer fails in overcoming the Department's *prima facie* case unless it proves by documentation that the business activities the Department infers never occurred. This argument by the Department would require "Le Croissant" to produce documentary evidence of business activity and a business relationship between "Le Croissant" and "Greenjeans" that never existed. It is not possible for anyone to document the non-existence of business activity

that never occurred or to document the non-existence of an alleged business relationship that never existed.

What is persuasive is that none of the documentation or testimony introduced by the Department refutes Mr. "Gibb's" testimony. For example, the Department states in its brief that "the overwhelming evidence shows that there is a direct link between ["Le Croissant's"] specialty vegetable oil business (the business that derived from the recombinant DNA research going back to "Greenjeans") and the State of Illinois." Dept. brief p. 34. In support of that statement, it cites its Exhibit No. 2, pages 23, 24 and 29. These pages are arithmetic schedules having to do with apportionment factors. They do not mention "Greenjeans" or recombinant DNA or vegetable oil. They do not support the allegation for which they are cited. The Department's allegation is based on an inference that is not supported by the record. There is no evidence in the record that the "Greenjeans" research ever had any connection to any "Le Croissant" product or any business of "Le Croissant" in Illinois.

Finally, the Department asserts that the decision in *Hercules* does not apply to this case, apparently on a perceived material factual distinction. The distinction is that Hercules disposed of a business that it had previously engaged in when it sold its Himont stock, whereas the Department asserts that "Le Croissant" and "Greenjeans" were functionally connected because the "Greenjeans" investment enabled "Le Croissant" to develop vegetable oils that were substituted for mineral oil as a major lubricant used in hydraulic fuel used in tractors and other two-cycle equipment. Department brief, page 5.

The Department cites as evidence of this connection Department Ex. No. 14, p. 6, Department Ex. No. 24, p. 3, and Department Exhibit 22, p. 12. Department Ex. No. 14, p.

6 is a page from "Le Croissant's" annual report to shareholders for 1986. It explains why sales of seeds in the agribusiness were less in 1986 than they were in 1985. It refers to "Le Croissant's" efforts to develop superior crop seeds and vegetable oils using the latest technologies, including biotechnology, but "Greenjeans" is not mentioned on the page cited. Department Ex. No. 24, p. 3 is a page from a Form 10-K "Le Croissant" filed with the Securities and Exchange Commission for 1993. That page discusses fuel and lubricant additives "Le Croissant" makes and states that the raw material for most of them is petroleum. Neither "Greenjeans" nor vegetable oils are mentioned. Department Ex. 22, p. 12 is a page from "Le Croissant's" 1994 annual report to shareholders. It mentions lubricants made from vegetable oil, but it does not mention or suggest that "Greenjeans" or any "Greenjeans" technology was involved in developing these lubricants or that "Greenjeans" technology provided "Le Croissant" its window on DNA technology as alleged by the Department. Thus, the alleged connection between "Greenjeans" and "Le Croissant" is another inference made by the Department that is not supported by the record.

The Department has failed to disprove Mr. "Gibb's" testimony that "Greenjeans" research did not apply to "Le Croissant"'s business, nor does it refute his testimony that the type of research that "Greenjeans" conducted on the human genome was completely different from the research "Le Croissant" conducts. There is no evidence that the "Le Croissant" investment in "Greenjeans" stock was functionally operational as alleged by the Department.

Conversely, the taxpayer argues that the decision *in Hercules, Inc. v. Dept. of Revenue*, *supra*, and the precedents upon which it is based are controlling in this case. I agree.

In 1983, Hercules was a chemical manufacturing and aerospace company that operated throughout the United States and foreign countries. Incorporated in Delaware, Hercules maintained a sales office in Illinois and occasionally stored inventory in a public warehouse in Chicago. The main business of the Illinois office was the sale of industrial chemicals.

Prior to November 1, 1983, Hercules was a global manufacturer of polypropylene, a petroleum-based plastic. Between 1981 and November 1, 1983, Hercules sold over \$1 billion worth of polypropylene which amounted to 15% of its sales. Hercules did not maintain the technology to economically produce polypropylene, so when the price of oil increased it decided to reduce its reliance on this product. On November 1, 1983, Hercules entered into a joint venture agreement with an Italian corporation by the name of Montedison. This agreement created a Delaware corporation named Himont to take over all aspects of the manufacture and sale of polypropylene. Himont's principal place of business was in Delaware.

In exchange for 50% of the stock of Himont, Hercules contributed to Himont all of its assets involved in the manufacture and sale of polypropylene. All of Hercules employees involved in making polypropylene resigned their positions with Hercules and became employees of Himont. Montedison received 50% of Himont's stock in exchange for \$180,000, its polypropylene manufacturing business, and a new more efficient process for manufacturing the product.

Initially, both Hercules and Montedison appointed three directors to Himont's board of directors. Hercules also selected Himont's president, three out of six vice-presidents, its chief financial officer, and its controller. Hercules and Himont never had

common officers or employees, and no Hercules employees were involved in the day to day operations of Himont.

Between 1983 and 1987, Hercules provided Himont with a variety of services, such as advertising, public relations, controller, engineering medical, legal, tax and audit, billing, purchasing and information technology. Himont paid Hercules for these services at a rate that an independent accounting firm determined was comparable to amounts charged by unrelated companies. Hercules agreed to purchase 80% to 85% of its polypropylene from Himont between 1983 and 1987, under terms that included a 2.5% discount to reflect marketing cost savings. The accounting firm determined that these terms were fair market pricing terms.

On February 12, 1987, Himont sold 22.6% of its common stock in its initial public offering. Following this public offering, Hercules and Montedison each owned 38.7% of Himont's stock. In September 1987, Montedison threatened to take over Hercules if Hercules would not sell to Montedison its remaining shares in Himont. As part of the proposed purchase, Montedison agreed to pay a premium for the stock owned by Hercules. Hercules accepted the offer to sell its shares to Montedison, and in 1987 Montedison paid Hercules \$1,487,500,000, or \$59.50 per share, resulting in a net capital gain to Hercules of \$1,338,501,966.

Hercules reported its capital gain from the sale of the Himont stock to Montedison as nonbusiness income on its 1987 Illinois income tax return. After auditing Hercules, the Department determined that this capital gain constituted business income.

The Court in *Hercules* began its analysis by reiterating the two tests adopted by the U.S. Supreme Court to determine whether a state can apportion income of a non-

domiciliary corporation. These tests are the “unitary business relationship” test and the “operational function” test. 324 Ill.App.3d at 336. Both of these tests were articulated by the U.S. Supreme Court in *Allied-Signal, supra*, 504 U.S. at 787. If the capital gain in question is derived either from a unitary relationship between the source of the gain and the recipient or from a capital transaction that served an operational function, the gain can be apportioned without taxing extra-territorial values prohibited by the Due Process and the Commerce clauses. *Id.* The unitary business relationship is demonstrated by establishing functional integration, centralization of management and economies of scale. *Id.* at 783. The income passes the operational function test if the underlying asset is used in the taxpayer’s business activities conducted within the taxing state. *Id.* at 785.

In the *Hercules* case, the Department conceded that there was no unitary relationship between Montedison and Hercules because they were separate corporations that entered into a joint venture. *Hercules, supra*, at 337. In addition, the Act requires 50% ownership in an affiliate before it can be a member of a unitary business group. 35 ILCS 5/1501(a)(27).

In determining whether the Himont investment served an operational function, the *Hercules* court looked for factors showing centralized management, functional integration and economies of scale. The court found that there was no centralized management because Hercules could not control the board of directors and it shared no officers or employees with Himont. It had no control over the management of Himont. The fact that Hercules created Himont, supplied its workforce, and chose three members of its seven-person board did not show that the investment served an operational function for Hercules. 324 Ill.App.3d at 338. The fact that Hercules provided Himont with a variety of

administrative services, such as advertising, public relations, controller, engineering, medical and other services and contributed substantial assets to Himont, did not show an operational relationship because Hercules charged Himont for those services at market rates. Finally, the *Hercules* court found no flow of value between Himont and Hercules. The polypropylene it purchased from Himont was purchased at market value pricing. Since centralized management, functional relationship, and economies of scale were not demonstrated, the record did not establish an operational purpose. *Id.* at 339.

In the instant case, for the capital gains in question to pass the operational function test the underlying asset, the "Greenjeans" stock or "Greenjeans" assets or technology, would have to have been used in "Le Croissant's" business activities conducted within Illinois. The human genetic technology being developed by "Greenjeans" was completely different from the technology used by "Le Croissant". The record demonstrates that the "Greenjeans" stock was never used as collateral or for any other purpose. There is no evidence that "Le Croissant" ever used any "Greenjeans" assets or technology during the years at issue in any of its operational business activities.

The indicia of a unitary business relationship are centralized management, functional integration and economies of scale. "Le Croissant" never owned more than 20% of the outstanding stock of "Greenjeans". For that reason, it was prohibited by statute from being included in the "Le Croissant"'s unitary business group. Except for the period 1979 to 1988 during which an employee of "Le Croissant" served on the board of directors of "Greenjeans", "Le Croissant" and "Greenjeans" did not share directors, so "Le Croissant" was never in a position to dictate action of the "Greenjeans" board of directors. "Le Croissant" and "Greenjeans" never shared officers or employees and "Le Croissant" never

provided administrative services of any kind to "Greenjeans", so there was no centralized management or functional integration. "Le Croissant" never purchased anything or utilized any "Greenjeans" technology so there were no economies of scale. Therefore, there was never an operational relationship under the operational function test.

Because the record demonstrates that the capital gain in question does not pass either the unitary business relationship test or the operational function test, including it in "Le Croissant's" apportionable business income would violate both the Due Process Clause and the Commerce Clause by taxing extraterritorial income.

The taxpayer has presented testimony and documentary evidence sufficient to overcome the Department's *prima facie* case. In addition, the taxpayer has demonstrated that taxation of the gains in issue as business income by Illinois would violate the Due Process and Commerce Clauses of the U.S. Constitution. For the reasons set forth above, I recommend that the Notice of Deficiency be cancelled.

September 25, 2002

Charles E. McClellan
Administrative Law Judge